Supreme Court, U. S.
FILED
FEB 23 1977
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IN THE SUPREME COURT OF THE UNITED STATES

October Term, 1976

No. 76-1165

ZOLLER & DANNEBERG EXPLORATION, LTD. and ZOLLER & DANNEBERG, INC.

Petitioner,

vs.

THE BALLARD & CORDELL CORPORATION,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

WILLIAM R. FISHMAN
Counsel for Petitioner
2500 First National Bank Building
Denver, Colorado 80293

DAVID H. DRENNEN
Of Counsel
2500 First National Bank Building
Denver, Colorado 80293

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

Petitioner prays that a Writ of Certiorari issue to review the judgment of the United States Court of Appeals for the Tenth Circuit entered in the above case on November 11, 1976; Petition for Rehearing denied on December 13, 1976.

CITATIONS TO OPINIONS BELOW

The opinion of Judge Chilson granting in part and denying in part Plaintiff's

and Third-Party Defendants' Motion to Dismiss or Motion for Summary Judgment is unreported and appears in Appendix A, infra. The judgment and opinion of Judge Chilson was not reported and appears in Appendix B, infra. The opinion of the Court of Appeals is reported in 544 F.2d 1059, and appears in Appendix C, infra. Order denying Petition for Rehearing was not reported and appears in Appendix D, infra.

JURISDICTION

The judgment of the Court of Appeals was entered on November 11, 1976, Petition for Rehearing denied on December 13, 1976. Jurisdiction of this Court is invoked under 28 U.S.C. Section 1254(1).

QUESTIONS PRESENTED

Whether a 50% undivided interest in an oil and gas lease constitutes a "security", as defined by Section 2(1) of the Securities Act of 1933 and Section

3(a)(10) of the Securities Exchange Act of 1934.

STATUTES INVOLVED

1. Section 2(1) of the Securities Act of 1933, 15 U.S.C. §77b(1):

> "Sec. 2. When used in this title, unless the context otherwise requires --
>
> "(1) The term 'security' means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, or, in general, any interest or instrument commonly known as a 'security,' or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing."

2. Section 3(a)(10) of the Securities Exchange Act of 1934, 15 U.S.C. §78c(a)(10):

> "Section 3.(a) When used in this title, unless the context otherwise requires --

* * * *

"(10) The term 'security' means any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit, for a security, or in general, any instrument commonly known as a 'security'; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited."

STATEMENT OF THE CASE

1. Background.

Zoller & Danneberg, Inc. and Zoller & Danneberg Exploration, Ltd. are corporations organized under the laws of the State of Colorado; Zoller & Danneberg Exploration, Ltd. is a wholly-owned subsidiary of Zoller & Danneberg, Inc. (For purposes of this Petition, both entities will be referred to as "ZDI".) The Ballard & Cordell Corporation ("B&C") is a corporation organized under the laws of the State of Georgia.

In and about July, 1972, B&C was in serious need of funds with which to continue its operations and with which to repay pressing bank loans. B&C offered for sale fractional undivided interests in two leases which were owned by the '70-'71 Partnership, which B&C managed as General Partner. One producing well was on each of the two leases offered

for sale -- the Adams No. 1 Well and the Eversole No. 1 Well. B&C had overspent several hundred thousand dollars for the account of that partnership and was, therefore, forced to sell the interests in those leases to repay itself for the advances it made to the '70-'71 Partnership. There was no additional acreage to drill on either of those leases. Any purchaser would acquire nothing more than a fractional undivided interest in a producing gas well and would rely upon the production from those wells to obtain a return on its investment plus a profit.

On or about August 1, 1972, B&C forwarded to several companies, including ZDI, brochures prepared by it regarding the two gas wells, which brochures were represented as including "all the necessary data needed to evaluate" the wells. ZDI was already the owner of a 25% interest

in the Adams No. 1 Well and was a joint venturer with B&C in drilling that well. It had no interest in the Eversole No. 1 Well. Based upon the brochures and the information contained therein, ZDI entered into negotiations with B&C regarding B&C's interests in the Adams No. 1 Well and subsequently began to negotiate for B&C's interests in the Eversole No. 1 Well.

Keplinger & Associates, Inc. ("Keplinger") was an independent consulting petroleum engineering and geological firm [whose reserve estimates B&C used in the preparation of its financial statements and income tax returns and on whose estimates B&C relied in justifying the carrying value of its advances to the limited partnerships on its financial statements]. At the request of B&C, on August 14, 1972 Keplinger wrote the Texas Oil & Gas Corporation ("Texas"), the operator of the wells,

seeking updated information on the wells. By letter dated August 22, 1972, Texas furnished to Keplinger updated production and pressure data on both wells. The pressure data indicated that pressure tests had been made on both wells on July 30, 1972, which tests indicated a sharp, significant drop in the pressure in both wells. The pressure reading on producing gas wells is the single most important factor in determining the amount of remaining reserves. Drops in pressure, along with the cumulative production data, indicated that the actual gas reserves remaining in the wells were significantly lower than had been previously estimated by both B&C and Keplinger and indicated that the wells did not have any significant economic value.

On August 24, 1972, after receiving the above information from Texas, Keplinger wrote B&C and made the following statement:

> "From these plots it is pretty clear that these wells are not as good as we have given credit for in our prior reports. These wells may do a little better than my new estimates, but at any rate they probably won't last much longer.
>
> "As to what to sell these wells for, I think the above figures, data and curves speak for themselves." (Emphasis added.)

Keplinger also prepared and enclosed pressure versus cumulative production plots utilizing the new pressure data which showed that both wells had minimal reserves remaining. The new Keplinger estimates were used by B&C in their federal tax returns for depletion purposes and certified financial statements to shareholders. Keplinger reduced its estimates of remaining reserves on the Adams No. 1 Well by approximately 80%. B&C did not disclose the new adverse pressure data and the fact that the wells had insignificant reserves and would not last much longer to ZDI.

Prior to December, 1972, ZDI, although it had made inquiry, did not know pressure tests had been made on the Adams No. 1 Well on July 30, 1972; did not know the results of that test; had not seen a pressure versus cumulative production plot based on the July 30, 1972 pressure test and cumulative production to date; did not know that Keplinger had stated that the wells wouldn't last much longer; and did not know the wells had virtually no reserves remaining. Had B&C disclosed those facts, ZDI would not have made an offer to purchase B&C's interest in those wells.

Negotiations continued for sale of the wells until September, 1972. On September 8, 1972, ZDI sent a telegram to B&C confirming a prior telephone conversation in which ZDI had agreed to purchase B&C's interest in both wells. On November 3, 1974, Texas filed the

adverse pressure test results on the Adams No. 1 Well with the Oklahoma Corporation Commission, thereby making that information public for the first time. On the same date (November 3), B&C wrote ZDI seeking to close the Adams No. 1 Well deal prior to the Eversole No. 1 closing. By letter dated December 15, 1972, ZDI notified B&C that it was withdrawing its offer to purchase B&C's interest in the leases.

2. Court Proceedings.

B&C filed this lawsuit on April 30, 1973. Jurisdiction of the District Court was based on diversity of citizenship, 28 U.S.C. §1332(a). In its Complaint, B&C alleged that ZDI had breached its contract for the sale of a 50% interest in oil and gas leases and sought specific performance of the contract or, alternatively, damages. In answer to the Complaint, ZDI denied that it had contracted to purchase the interest and raised various

affirmative defenses. In its Amended Complaint, B&C sought additional damages for amounts expended in attempting to mitigate its damages by reworking a well on one of the lease interests.

On or about October 31, 1973, ZDI filed its Answer to the Amended Complaint and a Counterclaim. In its Answer, ZDI, in addition to the denials contained in its original Answer, raised seven affirmative defenses, including that the interests in the wells which B&C allegedly sold to ZDI were securities as defined by the Securities Act of 1933 (the "1933 Act") and the Securities Exchange Act of 1934 (the "1934 Act"); and that B&C, in the offer and attempted sale of the securities, violated Section 12(2) of the 1933 Act, Section 10(b) of the 1934 Act, and Rule 10b-5 thereunder; and that any contract entered into by ZDI as a result of such violation is voidable by ZDI.

In its Counterclaims ZDI realleged violations of the above sections of the 1933 Act and 1934 Act, realleged common law fraud, and sought damages.

In a motion filed on or about December 5, 1973, B&C and the Third-Party Defendants moved the Court to strike three affirmative defenses of ZDI's Answer (the defenses which alleged fraud and violations of the Securities Acts); to dismiss three counts of ZDI's Counterclaim; or, alternatively, to enter partial summary judgment in B&C's favor against ZDI with respect to the three affirmative defenses and the three counts of ZDI's Counterclaim. The trial court, after hearing argument, issued the Order dated October 9, 1974 granting partial summary judgment to B&C (Appendix A). The Court, in that 1974 Order, held that the interests offered by B&C were not securities, as defined by the 1933 Act and/or the 1934 Act and,

therefore, dismissed the affirmative defenses and Counterclaims raised under those Acts.

Trial was had to the Court on September 22, 23, and 24, 1975 on all issues. On October 22, 1975, the Court entered its Findings of Fact, Conclusions of Law and Order and Final Judgment. Appeal was taken by ZDI from the Final Judgment and from the 1974 Order. ZDI appealed the Court's Orders to the United States Court of Appeals for the Tenth Circuit, which affirmed the judgment and Order of the District Court.

ARGUMENT

A. The Court below held that a fractional undivided interest in an oil and gas lease is not a "security" if the seller transfers its entire fractional interest to one purchaser. That, even though the interest is fractional, the interest was not a security because the seller did not "fractionalize" its interest. This Court has never decided that specific question. As evidence of the uncertainty in the area, quite recently the Securities and Exchange Commission declined to express an opinion upon whether similar interests are "securities". Olympic Petroleum Co., CCH Fed. Sec. L.Rep. ¶80,793 (1976).

This Court has held that the definition of "securities" in the Securities Exchange Act of 1934 (the "1934 Act") must be read in pari materia with the definition in the Securities Act of 1933

(the "1933 Act"). Most cases, accordingly, have dealt primarily with the 1933 Act's definition.

REASONS FOR GRANTING THE WRIT

The Writ of Certiorari should be granted because the Court of Appeals interpreted a section of the federal securities laws of signal importance to the oil and gas industry. The decision is in conflict with the decisions of three other Courts of Appeal (5th, 8th, and 9th Circuits) construing what constitutes a "security" and one Court of Appeals (4th Circuit) with respect to fractional undivided interests in oil and gas wells. Moreover, it is in direct contradiction to the writings of leading commentators in the securities field. In addition, the Court below has held, in effect, that if a fractional undivided interest in a well is sold to two people it is a security because it has been fractionalized,

but if it is sold to one person it is not a security. This Court should review that decision.

The Securities Act of 1933 includes within its definition of "security" any fractional undivided interest in oil, gas, or other mineral rights. This Court has stated that in determining the existence of a "security", the definition should be construed liberally, in keeping with the broad remedial policies of the federal securities laws. J. I. Case Co. v. Borak, 377 U.S. 426 (1964). In S.E.C. v. Joiner, 320 U.S. 344 (1943), the Court noted that oil and gas rights posed a difficult problem to the legislative draftsman. To avoid placing undue burdens on the oil and gas industry, Congress included specifically only forms of mineral interests which had been most utilized for speculation. The interests specifically included by Congress were

"fractional undivided interests". The Court stated:

> "Instruments may be included within any of these definitions, as a matter of law, if on their face they answer to the name or description." Id., at 351.

Such is the case herein.

The Court below primarily relied on the language in two earlier decisions to support its ruling -- Woodward v. Wright, 266 F.2d 108 (10th Cir. 1959), and Gilbert v. Nixon, 429 F.2d 348 (10th Cir. 1970). Yet most of that language related to the question of whether or not a public offering was made by the seller. The Court in each of those earlier cases had held that the interests sold were securities, since the seller had fractionalized his own interest and sold the fractionalized interests. Neither Woodward nor Gilbert reached the question of whether one selling his entire fractional interest does not sell a security

-- although the decision in Woodward contained dicta to that effect.

The Fifth Circuit Court of Appeals, in Lynn v. Caraway, 379 F.2d 943 (5th Cir. 1967), affirmed a District Court's ruling that a seller had not issued a security because he sold all of his interest in a lease and had not created a fractional undivided interest in the lease. A study of that case shows that the seller had not even sold a fractional undivided interest in the lease, since the seller owned and sold the entire working interest in the lease. Accordingly, the present case is the first case decided by a Court of Appeals which contains facts squarely on point.

The relevance of whether or not the seller of a particular interest himself fractionalized the interest was misunderstood by the Courts. The answer to that question should not be used to determine

whether or not the interest is a security, but rather it should be determinative of whether or not the seller is an issuer, as that term is defined in the 1933 Act. Section 2(4) of the 1933 Act reads, in relevant part, as follows:

> ". . .[W]ith respect to fractional undivided interests in oil, gas, or other mineral rights, the term 'issuer' means the owner of any such right or of any interest in such right (whether whole or fractional) who creates fractional interests therein for the purpose of public offering." (Emphasis added.)

The determination of whether one is an "issuer" goes to the question of whether the "issuer" must register the securities for sale. It does not go to the definition of a "security". Whether one is an issuer is not relevant to the question of whether a "security" is being offered and sold.

In a fairly recent article, Pesnell, Securities Regulation in Oil and Gas Transactions, 17th Institute on Mineral

Law, 33, 38 (1970), the distinction was explained:

> ". . . Whether a fractional oil and gas interest is a 'security' is a question entirely separate and distinct from the question whether a 'public offering' is involved. The Court of Appeals [for the Tenth Circuit]. . . recognized this in Woodward, [supra], for it held that there was no public offering of the fractional leasehold interests sold and, consequently, the sellers were not 'issuers' or (sic) securities. The court nevertheless held that the fractional leasehold interests sold were 'securities' under the Securities Act of 1933 and rescinded the sale because the sellers had violated §12(2). Thus, the court's own analysis convincingly demonstrates that it is not necessary for the sellers to be 'issuers' in order to have a 'security'. In other words, there can be a 'security' without an 'issuer'.
>
> ". . . The court is quite correct in saying that [in a case where the seller transfers all that he owns] the seller. . . has not 'created' any undivided fractional interests in oil and gas rights. This merely shows, however, that the seller is not an 'issuer'; it does not demonstrate that the fractional interest sold is not a 'security'. Suppose A creates twenty-five equal fractional interests in a lease and offers them for sale to the public. B buys one of the interests for investment and

three years later decides to sell his interest. The court in Woodward would undoubtedly say that A had sold 'security' to B. How, then, does the fractional interest cease to be a 'security' in the hands of B when he offers his entire interest for sale?

"This is not to say that the Securities Act of 1933 necessarily applies to B's transaction in the same way it applies to A's transaction. A, having created the fractional interests for the purpose of a public offering, would be an 'issuer' and would be required to file a registration statement covering the 'securities'. B, on the other hand, would not be required to register the sale of his fractional interest, because he is not an 'issuer', 'underwriter' or 'dealer' under the Securities Act of 1933. B will nevertheless be required by §12(2) of the 1933 Act to make a full and complete disclosure of the material facts affecting the fractional interests under potential plans of rescission by the purchaser if he fails to do so." (Emphasis added.)

Professor Bloomenthal, in his treatise, Securities and Federal Corporate Law, also clarifies the fact that whether or not the oil and gas interest is fractionalized by the seller is important

only to determine if the seller is an issuer under the 1933 Act. His example precisely covers the case at hand. On Page 2-108, he gives the following example:

> "The aspect of the definition of an 'issuer' that gives rise to interpretative problems involves the question of whether one has created fractions. If A, for example, owns an oil and gas lease and sells and assigns an undivided one-half interest to B, A has sold a security and is also the issuer of the security if a public offering is involved. If B then assigns his entire one-half interest in the lease to C, B has sold a security but he is not the 'issuer' of a security. Accordingly, the transaction not involving an issuer, underwriter, or dealer is exempt from the registration provisions of the Securities Act. However, since a sale of a security is involved, it is subject to the fraud provisions of both the Securities Act and the Exchange Act. . . ." (Emphasis added.) H. Bloomenthal, Securities and Federal Corporate Law, §2.20[1], at 2-108, in 3 Securities Law Series (1975).

The ruling of the Court below permits the holder of a fractional undivided interest in an oil or gas lease to sell it to anyone, if he does not fractionalize it, free of all obligations of disclosure

imposed by the federal securities laws. We respectfully suggest that the import of that decision is of such magnitude that it should be reviewed by this Court.

The interest offered by B&C was a 50% interest in an oil and gas lease and, as such, was a fractional interest. The fact that B&C offered its entire interest in the lease does not change the basic nature of the interest: it was still a fractional interest, and it was still a security. Creswell-Keith, Inc. v. Willingham, 160 F.Supp. 735 (W.D. Ark. 1958); rev'd. on other grounds, 264 F.2d 76 (8th Cir. 1959). The character of the transaction would be the same if B&C sold 25% to ZDI and 25% to Exxon. Yet, under those circumstances, the Court below would have held the interests to be securities because B&C "fractionalized" its 50% interest.

The Court below affirmed the trial court's ruling, on summary judgment, that the interest sold by B&C was not an "investment contract" as that term is used in the 1933 Act and the 1934 Act to define a "security". In reaching its decision, the Court held that ZDI, the purchaser, did not rely solely on the efforts of a third person, as apparently required by this Court in S.E.C. v. W. J. Howey Co., 328 U.S. 293. In that case, this Court defined an investment contract as "a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party. . . ." Id., at 298, 299.

The court below placed undue emphasis on the "solely" terminology of Howey. Three other Courts of Appeal have applied a less literal test to prevent frustration

of the remedial purposes of the Securities Acts. The test, as stated by the Ninth Circuit, is "whether the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise." S.E.C. v. Glenn W. Turner Enterprises, 474 F.2d 476, 482 (9th Cir. 1973), cert. denied, 414 U.S. 821 (1973). Accord, S.E.C. v. Koscot Enterprises, Inc., 497 F.2d 473 (5th Cir. 1974); and Miller v. Central Chinchilla Group, Inc., 494 F.2d 414 (8th Cir. 1974). In United Foundations, Inc. v. Forman, 421 U.S. 837 (1975), this Court, though noting the Turner decision, expressed no view as to its holding.

This Court, in a unanimous decision, held that in construing the term "security", "form should be disregarded for substance and the emphasis should be on

economic reality". Tcherepnin v. Knight, 389 U.S. 332, 336 (1967).

The economic reality of the present case is that ZDI was called upon to determine whether to make an investment. All that was offered was a 50% interest in a producing well. There was no additional acreage to drill. If the investment were made, ZDI would be acquiring nothing more than an interest in producing gas wells or, more precisely, an interest in the then existing gas reserves. ZDI would then rely solely upon the production from those reserves in order to obtain a return on its investment plus a profit.

A similar interest was held to be a security by the District Court and affirmed by the Fourth Circuit. In Johns Hopkins University v. Hutton, 297 F.Supp. 1165 (D. Md. 1968); aff'd. 422 F.2d 1124 (4th Cir. 1970); cert. denied, 416 U.S. 916 (1974), the defendants sold to John

Hopkins University ("Hopkins") a production payment from certain oil and gas wells. The reserves of oil and gas from which the production payment was to be made were substantially less than represented. There, as here, the defendants withheld certain adverse reserve estimates, which was held to constitute fraud. The Court held the production payment to be a "security" under both the 1933 and 1934 Acts.

The courts below relied on the terms of an operating agreement between the operator of the wells and participants in the production to ascertain the degree of control offered ZDI. The courts enumerated managerial decisions available to ZDI: Withholding of consent for incurrence of operating expenses in excess of $5,000 for the drilling of new wells on the unit area, and for the reworking, plugging back, or deepening of any existing wells. Those "decisions" in actuality

contained no aspects of meaningful control, because most of the management decisions granted to the non-operators by that agreement had already been made. ZDI, as stated previously, was offered a totally passive investment: the well site had already been located, the well drilled, the decision whether to drill beyond casing point made. The only time that operating expenses, at the point that ZDI would enter, would exceed $5,000 would be if a decision was made to plug the well. The unit area offered contained no acreage on which additional wells could be drilled, so that any possible decision of whether to drill additional wells could not arise. The only remaining decision -- whether or not to plug and abandon the wells if they no longer produced -- could not really affect the success or failure of the venture; that would be a decision of how best to minimize losses.

The "essential managerial efforts", then, had either already been made, or would be made by parties other than ZDI.

B. The trial court decided the question of whether an investment contract was involved in the sale on Motion for Summary Judgment. The Court of Appeals approved the appropriateness of that ruling on summary judgment. However, that decision conflicts with a ruling of the Fifth Circuit in Roe v. U.S., 287 F.2d 435, 440 (5th Cir. 1961), which stated:

> "By its very nature, it is the peculiar facts of the setting which turns the offer from a mere sale of property into a sale of a security. That means that the trier of fact. . . must determine the issue."

See also, Hector v. Wiens, 533 F.2d 429 (9th Cir. 1976).

CONCLUSION

For the reasons set forth above, it is respectfully submitted that this Petition for a Writ of Certiorari should be granted.

William R. Fishman

David H. Drennen

APPENDIX "A"

IN THE UNITED STATES DISTRICT COURT

FOR THE DISTRICT OF COLORADO

Civil Action No. C-4970

THE BALLARD & CORDELL CORPORATION,

Plaintiff,

vs.

ZOLLER & DANNEBERG EXPLORATION LTD.; ZOLLER & DANNEBERG INC.,

Defendants and Counter-Plaintiffs,

vs.

THE BALLARD & CORDELL CORPORATION; WILEY P. BALLARD, JR.; and ROBERT R. DURKEE,

Counter-Defendants.

Seawell, Cohen & Sachs, Attorneys at Law, by Thomas C. Seawell and Jeffrey L. Smith, 1660 Lincoln Street, Suite 1518, Denver, Colorado 80203, for Plaintiff and Counter-Defendants; William R. Fishman, Attorney at Law, 2500 First National Bank Building, Denver, Colorado 80202, for Defendants; Burns and Wall, Attorneys at Law, by Peter J. Wall, 1680 Colorado State Bank Building, 1600 Broadway, Denver, Colorado 80202, for Defendants.

OPINION AND ORDER

CHILSON, Judge

This is an action in diversity for breach of a contract to purchase certain oil and gas interests. Plaintiff alleges that it agreed to sell and defendant, Zoller & Danneberg Exploration, Ltd., agreed to purchase for $105,000, plaintiff's entire interest in certain oil and gas leases. Plaintiff's entire interest consisted of an undivided 50% interest in said leases. Plaintiff alleges that defendant exploration company repudiated the contract and that plaintiff stands ready to execute and deliver the assignment of the lease interests to defendants. Plaintiff prays for specific performance or, in the alternative, for damages against defendant exploration company and also against defendant, Zoller & Danneberg, Inc., as the alleged assignee of the exploration company's rights under the contract.

Defendants' amended answer to the amended complaint denies the existence of a valid contract, sets forth seven affirmative defenses and asserts a counterclaim containing three counts.

Defendants add Wiley P. Ballard, Jr. and Robert R. Durkee as "Additional Defendants on Counterclaim." These parties joined with plaintiffs in filing that motion to dismiss or for summary judgment on the fifth, sixth and seventh affirmative defenses and all three counts of the counterclaim.

The fifth, sixth and seventh affirmative defenses and the three counts in

the counterclaim are all based upon allegations of misrepresentation or omission of material facts during the negotiation stages. Defendants allege that when the offer was made by plaintiff to sell its interest, said offer was accompanied by a brochure represented to contain current information concerning the wells; that subsequent to the start of negotiations, plaintiff had an engineering company update information concerning the production status of the wells; that pressure tests showed there was a significant drop in pressure, indicating that the well reserves were much lower than had been previously estimated; that the engineering company expressed the opinion that the wells probably would not last much longer; and, that this was material information which a prudent investor would want to know in order to make an informed judgment as to the value of the wells.

The fifth affirmative defense sets forth common law fraud as a basis for rescission. The sixth and seventh affirmative defenses allege that the above misrepresentations or omissions of material fact violate § 12 of the Securities Act of 1933 and § 10(b) of the Securities Exchange Act of 1934 respectively, and provide grounds for rescission.

Count I of the counterclaim alleges that the misrepresentations or omissions of material fact are in violation of § 10(b) of the 1934 Act and prays for recovery of $7,000 in compensatory damages. Count II alleges that the misrepresentations or omissions are in violation of § 12(2) of the 1933 Act and prays for $7,000 in compensatory damages and $50,000

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in punitive damages. Count III is a common law fraud claim in which defendants pray for both compensatory and punitive damages. Defendants join as counter-defendants with plaintiffs, Wiley P. Ballard, Jr., and Robert R. Durkee.

Plaintiff and the other counter-defendants now move to strike the fifth, sixth and seventh affirmative defenses and to dismiss each count of the counterclaim or, in the alternative, for partial summary judgment on the fifth, sixth and seventh affirmative defenses and each count of the counterclaim.

As grounds for their motion, plaintiffs contend that the sale of one's entire interest in an oil and gas lease is not a "security" since there is no creation of a fractional oil and gas interest, or in the alternative, that the undisputed facts show that the contract for sale of the interests was not an "investment contract" and therefore was not a security under either the 1933 Act or the 1934 Act. Plaintiff further contends that there is no common law fraud claim because the defendants have failed to allege any basis for a duty owed by plaintiff to defendants to divulge the engineer's report.

Plaintiffs also move to dismiss that part of the counterclaim praying for punitive damages on the ground that such damages are not proper in suits under the 1933 Act.

Both parties have submitted briefs in support of and in opposition to the motions and oral argument was heard by the Court.

The motion should be granted with respect to the sixth and seventh affirmative defenses and counts I and II of the counterclaim, but should be denied with respect to the fifth affirmative defense and count III of the counterclaim.

Since the sixth and seventh affirmative defenses and counts I and II of the counterclaim are based upon the application of federal securities law, the issue to be determined pursuant to plaintiff's motion to dismiss is whether the interest to be transferred by the alleged contract was a "security" under either of the securities acts.

The term "security" is defined in § 2(1) of the Securities Act of 1933 to include any "investment contract" and any "fractional undivided interest in oil, gas, or other mineral rights." 15 U.S.C. § 77b (1). In § 3(10) of the Securities Exchange Act of 1934, "security" is defined to include any "certificate of interest or participation. . . in any oil, gas, or other mineral royalty or lease" and any "investment contract." 15 U.S.C. § 78c (10). Therefore, the issue becomes whether a 50% interest in certain oil and gas leases is a fractional undivided interest in oil, gas, or other mineral rights, an investment contract or a certificate of interest or participation in any oil, gas, or other mineral royalty or lease.

It has been held that if the seller transfers his entire interest in oil, gas or other mineral rights, a fractional undivided interest is not created, even though the seller's entire interest is

itself fractional in nature. Woodward v. Wright, 266 F.2d 108 (10th Cir. 1959). See also Lynn v. Caraway, 379 F.2d 934 (5th Cir. 1967), cert den. 393 U.S. 951 (1968); Graham v. Clark, 332 F.2d 155 (6th Cir. 1964). It is only when the seller transfers fractionalized portions of his entire interest that such interests become securities. Gilbert v. Nixon, 429 F.2d 348 (10th Cir. 1970); Woodward v. Wright, supra. Since plaintiff in the present case owned a 50% interest in certain oil and gas leases, and attempted to transfer the entire interest, no fractional undivided interest was created within the meaning of 15 U.S.C. § 77b (1).

However, the sale of an entire interest may involve an "investment contract," thereby qualifying as a security. Lynn v. Caraway, supra. An investment contract is a "contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party. . ." S.E.C. v. Howey Co., 328 U.S. 293, 299 (1946). See also S.E.C. v. Joiner Corp., 320 U.S. 344 (1943). The test for determining whether a particular transaction constitutes an investment contract is "whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others." S.E.C. v. Howey Co., 328 U.S. at 301. But an investment contract must transfer more than a "naked leasehold right," and usually involves additional economic inducements. S.E.C. v. Joiner Corp., supra; Roe v. United States, 287 F.2d 435 (5th Cir. 1961), cert. den. 368 U.S. 824 (1961).

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Investment contracts were discussed by Chief Judge Arraj in Mr. Steak, Inc. v. River City Steak, Inc., 324 F.Supp. 640 (D.Colo. 1970), modified 460 F.2d 666 (10th Cir. 1972). That case involved a franchise agreement wherein the franchisor retained extensive supervisory authority and the franchisee was given limited control over the daily operation of the business. In holding that the agreement did not constitute an investment contract, the Court identified a number of factors to be considered in making such a determination, including the nature of the investor's financial and managerial participation in the enterprise; the state of the investor's knowledge, skill and expertise concerning the enterprise; and, whether the investor is providing "risk capital" to finance a speculative venture. On appeal, the Court's analysis was quoted with approval. 460 F.2d at 669.

The present case appears to involve nothing more than the transfer of a leasehold right. Since plaintiff was attempting to transfer its entire interest and, upon sale would have been entirely removed from the enterprise, this is not a situation where the seller and buyer were entering into a common venture dependent for success upon the provision of capital by the buyer and management by the seller. The common enterprise, if any, existed between defendants and Texas Oil & Gas Corp., the independent operator of the wells.

Defendants were indeed relying on the efforts of the independent operator and the question is whether they were relying solely on the efforts of the operator, as required by the Howey test.

The terms of the operating agreement gave defendants limited participation in the operation of the wells. Defendants were required to pay a stated percentage of the costs of operation, but could withhold consent for the incurrence of operating expenses in excess of $5,000, for the drilling of new wells on the unit area, and for the reworking, plugging back, or deepening of any existing wells (Exhibit A, p. 4, attached to affidavit of Robert R. Durkee). In the event of non-agreement among the parties, any party wishing to pursue the above matters can do so and a dissenting party can elect not to participate in the proposed operation (Exhibit A, p. 5). Defendants can also participate in the selection of a new operator, should the present operator sell its rights (Exhibit A, p. 8). The decision to expend more than $5,000 or to drill a new well or rework an existing well is a managerial determination which may affect the failure or success of the enterprise. Since defendants have a voice in any such decision, they have significant managerial participation and this was one factor which helped the Court in Mr. Steak, Inc. to conclude that there was no investment contract because profits were not expected solely from the efforts of others.

Most investment contract cases involve the financing of speculative and poorly financed schemes by soliciting funds from uninformed and unskilled investors. See S.E.C. v. Joiner Corp., supra; Roe v. United States, supra; Continental Marketing v. S.E.C., 387 F.2d 466 (10th Cir. 1967). The Mr. Steak, Inc. analysis characterizes the investor as gambling

"risk capital" because there is little change (sic) of success, but there is also an opportunity for large profits. 324 F. Supp. at 646.

In the present case, defendants are far from being uninformed or unskilled in the type of venture involved. It appears that defendants' activities are concentrated in oil and gas production and exploration. Also, there is no indication that the enterprise was poorly financed, and the fact that the wells were producing negates the speculative nature of the lease. The attendant risk seems to be merely a normal risk of engaging in this type of business. Therefore, under the Mr. Steak, Inc. analysis the present facts do not give rise to an investment contract.

The only remaining possibility is that plaintiff was attempting to sell a security under the 1934 Act in the form of a "Certificate of interest or participation in any oil, gas, or other mineral royalty or lease." 15 U.S.C. § 78c (a)(1). No case has been found which states that a security is to be defined differently under the 1934 Act than under the 1933 Act. Since the definition of security under the 1934 Act is virtually identical to the 1933 Act definition, cases arising under the 1933 Act may be used to define "security" as used in the 1934 Act. Tcherepnin v. Knight, 389 U.S. 332 (1967). The 1934 Act is considered to be in pari materia with the 1933 Act and is intended to cover similar interests. Mr. Steak, Inc. v. River City Steak, Inc., supra. Therefore, the test to be applied under both statutes is identical. Wasnowic v. Chicago Board of Trade, 352 F. Supp.

1066 (M.D.Pa. 1972); Anderson v. Francis I. duPont & Co., 291 F. Supp. 705 (D.Minn. 1968). For the reasons articulated above, the present facts do not give rise to a security under the 1934 Act.

Plaintiff also contends that the fifth affirmative defense should be stricken as insufficient and count III of the counterclaim should be dismissed for failure to state a claim. Both the fifth affirmative defense and count III of the counterclaim are based on common law fraud. Plaintiff argues that defendants have not alleged that they were deceived by misstatements of present or past facts and have not alleged any basis for a duty to disclose the pertinent information.

The basic elements of common law fraud are set out in Morrison v. Goodspeed, 100 Colo. 470, 68 P.2d 458 (1937), as follows:

> (1) A false representation of a material existing fact, or a representation as to a material existing fact made with a reckless disregard of its truth or falsity; or a concealment of a material existing fact, that in equity and good conscience should be disclosed. (2) Knowledge on the part of the one making the representation that it is false; or utter indifference to its truth or falsity; or knowledge that he is concealing a material fact that in equity and good conscience he should disclose. (3) Ignorance on the part of the one to whom representations are made or from whom such fact is concealed, or the falsity of the representation or of the existence of the fact concealed. (4) The representation or concealment made or practiced with the intention that it shall be acted upon. (5) Action on the representation or concealment resulting in damage. 100 Colo. at 477-478.

Defendants allege that plaintiff neglected to inform them of certain well pressure tests and opinions indicating that the wells would not produce much longer; that such facts were material; that defendants were not aware of the information; that plaintiff was aware of the information and intended for defendants to act without knowledge of these material facts; that plaintiff intended to defraud defendants; and that defendants suffered damages as a result. There is no requirement that defendants allege a duty to disclose the information, and defendants appear to have stated a claim for common law fraud.

IT IS THEREFORE ORDERED that the motion to dismiss the sixth and seventh affirmative defenses and counts I and II of the defendants' counterclaim are granted and the motion to dismiss or in the alternative for summary judgment on the fifth affirmative defense and count III of the counterclaim is denied and the plaintiff and counterclaim defendants shall reply to count III of the counterclaim within fifteen days.

Entered this 9th day of October, 1974.

BY THE COURT:

By /s/ Hatfield O. Chilson
United States District Judge

APPENDIX "B"

IN THE UNITED STATES DISTRICT COURT

FOR THE DISTRICT OF COLORADO

Civil Action No. C-4970

THE BALLARD & CORDELL CORPORATION,

Plaintiffs,

vs.

ZOLLER & DANNEBERG EXPLORATION, LTD.; ZOLLER & DANNEBERG, INC.,

Defendants and Counter-Plantiffs,

vs.

THE BALLARD & CORDELL CORPORATION; WILEY P. BALLARD, JR.; and ROBERT R. DURKEE,

Counter-Defendants.

Mr. Jeffrey L. Smith, Attorney at Law, of the firm, Seawell, Cohen & Sachs, 1518 Lincoln Center Building, 1660 Lincoln Street, Denver, Colorado 80203, for Plaintiff and Counter-Defendants; Mr. William R. Fishman, Attorney at Law, 2500 First National Bank Building, Denver, Colorado 80202, for Defendants and Counter-Plaintiffs.

FINDINGS OF FACT, CONCLUSIONS OF LAW AND ORDER

C[illegible]ILSON, Judge

PRELIMINARY STATEMENT

The plaintiff and defendants were engaged in the business of exploring for and producing oil and gas. Plaintiff claims it entered into a contract with the defendant, Zoller and Danneberg Exploration Ltd. (ZDX), whereby defendant agreed to purchase and plaintiff agreed to sell plaintiff's 50% working interest in two producing wells in Oklahoma (Adams No. 1 and Eversole No. 1) and the oil and gas leases comprising the unit for each, for the sum of $105,000; that defendant breached the contract by refusing to complete the purchase, and plaintiff seeks recovery of resulting damages.

Admittedly, both defendants are jointly and severally liable for any recovery by plaintiff, although the transactions with plaintiff were carried on by ZDX.

Defendant denied liability alleging (See Pre-Trial Order):

1. The action is barred by the Statute of Frauds;

2. Plaintiff failed to furnish evidence of merchantable title to the leases involved;

3. That plaintiff was guilty of common law fraud for concealing and failing to disclose certain pressure test data in plaintiff's files and in failing to reveal the results of an evaluation of the wells by an outside engineering firm employed by plaintiff, all with the intent to defraud the defendant;

4. Plaintiff failed to promise performance.

Additionally, by supplemental designation of contested issues of law, defendant contends that under the evidence, defendant is not liable because:

a. Its consent to the contract was not free;

b. Defendant acted under a unilateral mistake of fact;

c. The parties were acting under a mutual mistake of fact;

d. Constructive fraud on the part of the plaintiff;

e. The contract should be reformed;

f. Plaintiff failed to mitigate damages. (See supplemental designation of contested issues of law filed September 8, 1975.)

Trial was had to the Court and the Court makes the following findings of fact.

FINDINGS OF FACT

At some time prior to August 1972, defendant had acquired a 25% working interest in the Adams No. 1 well and the leases comprising that unit, and plaintiff had acquired a 50% working interest in the same well and leases and also a 50% working interest in the Eversole No. 1 and leases comprising that unit. The operator of the well was Texas Oil and Gas Co. (Texas).

Plaintiff being in need of cash for its oil operations, offered for sale its 50% interest in the Adams and Eversole wells and the leases comprising the unit for each, and for this purpose, issued brochures (Exhibits U and V) and sent them to prospective purchasers including the defendant. In August 1972, plaintiff and defendant entered into a series of negotiations, offers and counter offers which finally culminated in defendant sending to plaintiff, the following telegram dated September 8, 1972, (Exhibit 14) which reads in pertinent parts as follows:

> "ATTN Robert R. Durkee Jr. This will confirm our telephone conversation of this date whereby Zoller and Danneberg Exploration Ltd. agreed to purchase your 50% working interest in the #1 Eversole well and the leases comprising the unit therefore and for your 50 percent working interest in the Adams Unit #1 well and the leases comprising the unit therefore for a total consideration of $105,000. This commitment to purchase is made subject to your ability to deliver merchantable title to the interest described in the sales brochure submitted with your letter August 1, 1972. Said purchase is to become effective as of 8 AM October 1, 1972. Letter will follow."

By letter to plaintiff dated September 12, 1972, (Exhibit 15) defendant confirmed the telegram and stated among other things "for the completion of our files, I would appreciate your advising in writing that our offer has been accepted."

The letter also requested among other things, an assignment of plaintiff's interest in all the leases comprising both the Adams and the Eversole units.

Although there does not appear in evidence a written acceptance to the offer, plaintiff sent the lease assignments and on September 26, 1972, defendant wrote plaintiff (Durkee, Exhibit HH) acknowledging receipt of "partial assignments of oil and gas lease which purport to convey your company's 50% interest - - -" in the two units. The letter stated "the assignments appear to be in proper form.", and further stated, "I wish to advise that we still need the following items prior to the payment of our purchase price:" The letter then lists the needed items as supplemental abstracts; additional title information on the Adams unit; title opinions and supplemental abstracts on the Eversole unit, and bills of sale and inventories of equipment being sold. Plaintiff supplied a large part of the requested material but not all of the title material requested.

Thereafter and until December 15, 1972, there was much correspondence and discussion among the plaintiff, defendant and defendant's title attorneys (Burns and Wall) pertaining to former title opinions, need for supplemental abstracts, defects in portions of the titles, the attorneys' requirements for correction of defects, all to the end that plaintiff furnish evidence of merchantable title to a 50% working interest in the two wells and the leases comprising their respective units.

On December 15, 1972, defendant wrote plaintiff as follows:

"RE: Adams Unit
Harper County, Oklahoma
Eversole Unit
Woodward County, Oklahoma

"Gentlemen:

"Please be advised that Zoller & Danneberg Exploration, Ltd. is withdrawing its offer to purchase your interest in the leases which cover the above referenced units.

"There have been numerous delays in your supplying Zoller & Denneberg (sic) Exploration, Ltd. with title information, which is still incomplete. Based upon the materials submitted, title to your interest in the above units is not merchantable while subject to outstanding requirements made by our attorneys.

"We are returning herewith the abstracts, title materials and assignments which were submitted."

The Court finds that evidence of merchantable title had not been furnished to defendant at that time.

The Court also finds from the evidence that given an opportunity to do so, the defects could have been corrected and the plaintiff could have furnished evidence of a marketable title as required by the defendant's offer to purchase (Exhibit 14).

During this period from September 1972 to December 15, 1972, the production and well pressure of Adams No. 1 had declined. This information was available to the defendant as an owner of a working interest in the Adams well.

The Court further finds that the defendant attempted to terminate the contract by its letter of December 15, 1972, because of the declining production and pressure of the Adams well and not because of the plaintiff's failure at that time to have furnished evidence of marketable title to the lands contained in the leasing units.

This finding is supported by the fact that in January 1973, Mr. Liles of Texas Oil and Gas, the operator, recommended that the Adams be abandoned and plugged since it was no longer commercially feasible to continue its operation. His recommendation was based on the well's declining production history and declining pressure as shown by a report filed with the State of Oklahoma in early November 1972.

That defendant's withdrawal was motivated by the condition of the Adams well and not by title insufficiencies is supported by the fact that in May 1973, although evidence of marketable title to all of the leasing units had not yet been furnished, the plaintiff and the defendant agreed to and did expend funds to rework the Adams well in the hopes of increasing its production. The Court finds that the declining production and pressure of the Adams well prior to December 15, 1972, together with the facts above set forth occurring between December

15, 1972, and May 1973, support a finding that the defendant attempted to terminate the contract because it turned out to be a bad deal and not because of title insufficiencies.

We turn our attention now to the claim of defendant that the plaintiff was guilty of fraud. This claim is based upon plaintiff's allegations that prior to September 8, 1972, when the defendant agreed to purchase the wells, the plaintiff had certain pressure data on the Adams well which it failed to disclose to the defendant. Admittedly, pressure data is one of the important factors in evaluating a well. Defendant's fraud claim is also based on the failure of plaintiff to reveal an evaluation of the Adams well which plaintiff had caused to be made in August 1972, by an outside consulting engineering firm (Keplinger). In the course of this evaluation, Keplinger requested of the operator, Texas Oil and Gas Co., information concerning production and pressure data on both the Adams and Eversole wells. Texas, among other things, advised Keplinger that a shut-in tubing pressure test taken during July 1972 disclosed a pressure of 960 p.s.i. (Durkee Exhibit N).

Keplinger used this information together with other available data and reported to plaintiff as follows:

> "RE: Adams #1 & Eversole #1
> Gas Wells
>
> "Dear Bob:
>
> "I finally received today the requested data from Texas Oil & Gas

> Corp. on the subject wells and attach a copy for your records. Also enclosed are pressure vs cumulative plots of the new data.
>
> "From these plots it is pretty clear that these wells are not as good as we have given credit for in our prior reports. These wells may do a little better than my new estimates, but at any rate they probably won't last much longer.
>
> "As to what to sell these wells for, I think the above figures, data and curves speak for themselves. Please advise if there are any questions."

The parties are agreed that the report of 960 p.s.i. pressure in July 1972 was erroneous. Mr. Liles of Texas testified the correct pressure data for the Adams was 900 p.s.i. in May 1972 and 625 p.s.i. in July 1972.

Erroneous or not, defendant contends plaintiff was under a duty to reveal that the Texas records stated a pressure of 960 p.s.i. for July.

The brochures (Exhibits U & V) which were sent to the defendant and which initiated the negotiations between the parties contained the following:

> "Purpose - The purpose of this report is to provide the information necessary for a preliminary evaluation of the above named property. Additional information and documentation for the data presented here may be inspected in the offices of the Ballard & Cordell Corporation in Lafayette, Louisiana."

The defendant did not seek additional information and documentation from the plaintiff, but employed its own consulting engineer, Norman Adams, to make an evaluation of the wells. In so doing, Norman Adams made his own investigation, including inquiry of the Texas Oil and Gas Company, the operator of the wells, for pressure and production information. For some reason not explained, Texas did not report to Norman Adams the July 1972 pressure of 960 p.s.i. which appeared in Texas records but there is no evidence that plaintiff was aware of this.

Defendant also alleges that there was fraud on the part of the plaintiff when it failed to reveal Keplinger's opinion contained in Exhibit N:

> "These wells may do a little better than my new estimates, but at any rate, they probably won't last much longer."

The Court finds that the failure of plaintiff to reveal to defendant the July 1972 pressure report of 960 p.s.i. furnished by Texas to Keplinger and contained in its report to plaintiff was not done with intent to defraud; that defendant was not misled since the pressure information was admittedly erroneous and since defendant did not know of the pressure test and did not rely on it.

The Court finds that Exhibit N was the expression of an opinion of value by an expert employed by plaintiff and as such is not a fact which plaintiff was under a duty to disclose to the defendant as a prospective purchaser.

Additionally, the Court finds from the evidence that in the oil and gas industry, such evaluations are not customarily exchanged between a prospective seller and a prospective buyer. This finding is reinforced by the fact that defendant did not disclose to the plaintiff the evaluation of the wells made by its expert Norman Adams. The Court finds no evidence which would impose a duty on either plaintiff or defendant to disclose the opinions of their respective experts.

The Court further finds that after the refusal of the defendant to perform the contract to purchase and after the abandonment of the Adams well, plaintiff sold its interest in the Eversoll (sic) well to Texas.

The Court finds that as a result of the breach of the contract by the defendants, the plaintiff has been damaged in the amount of $57,260.94 computed as follows:

Eversole No. 1:

Resale price 1/1/74		$28,000.00
Production 10/1/72-1/1/74	$31,323.12	
Expenses 10/1/72-1/1/74	-7,461.88	
	$23,861.24	
		23,861.24
		$51,861.24

Adams No. 1:

Production 10/1/72-date of plugging	$1,845.21	
Expenses 10/1/72-date of plugging (includes salvage credits)	-5,967.39	
	($4,122.18)	
		$(4,122.18)
		$47,739.06
		105,000.00
		-47,739.06
		$57,260.94

The evidence does not support the defendants' charge that plaintiff could have mitigated its damages and failed to do so.

The plaintiff is entitled to judgment against the defendants jointly and severally for its damages in the amount of $57,260.94, together with interest thereon from January 1, 1974, to this date at the rate of 6% per annum in the amount of $6212.81, and that plaintiff have judgment against defendants for its costs.

The Court further finds that the evidence does not support the counterclaims of the defendants and said counterclaims should be dismissed with prejudice. The Court further finds that the evidence does not support any of the defenses raised by the defendants and set forth in the pre-trial order and in the supplemental designation of issues of law filed by the defendant on September 8, 1975.

CONCLUSIONS OF LAW

The law of Oklahoma governs the application of the defense of Statute of Frauds raised by defendant. The Oklahoma

Statute of Frauds provides in pertinent part that certain contracts, including contracts for the sale of interest in real property, are "invalid, unless the same, or some note or memorandum thereof, be in writing and subscribed by the party to be charged, or by his agent - - -." 15 Okla. Stat. § 136 (1971). Under the facts as found by the Court, the telegram of September 8, 1972, (Exhibit 14) and the letter of September 12, 1972, (Exhibit 15) and the execution and delivery by plaintiff to defendant of the lease assignments of the lease units of the two wells and defendant's acceptance thereof constituted a compliance with the Statute of Frauds.

Under the facts as found by the Court, the Court concludes as a matter of law that the plaintiff was not guilty of fraud; that there was a legal contract between the parties; that the defendant's attempted withdrawal from the contract was not legally effective; that the other defenses of defendants heretofore set forth are without merit and plaintiff is entitled to judgment against the defendants jointly and severally in the amount of $63,473.75, together with plaintiff's costs.

Under the facts as found by the Court, the Court concludes as a matter of law that the counterclaims of the defendants are without merit and should be dismissed with prejudice.

APPENDIX "C"

544 F.2d 1059 (1976)

The BALLARD & CORDELL CORPORATION,
Plaintiff-Appellee,
v.
ZOLLER & DANNEBERG EXPLORATION,
LTD. and Zoller & Danneberg,
Inc., Defendants-Appellants and
Counter-Plaintiffs-Appellants,
v.
Wiley P. BALLARD, Jr. and Robert
R. Durkee, Additional Defendants-
Appellees on Counterclaim.

No. 75-1900

United States Court of Appeals,
Tenth Circuit.

Argued and Submitted Sept. 23, 1976.
Decided Nov. 11, 1976.
Rehearing Denied Dec. 13, 1976.

Action was instituted on claim for breach of contract and on counterclaim for alleged security violations. The United States District Court for the District of Colorado, Olin Hatfield Chilson, J., entered order dismissing counterclaims and, thereafter, entered judgment in favor of plaintiff, and defendant appealed. The Court of Appeals, Barrett, Circuit Judge, held, inter alia, that fractional working interests in two wells and lease units that defendant offered to sell plaintiff, when offered as a whole and not in further fractional interest, were not classifiable as an "investment contract" or as a "certificate of interest or participation in any oil, gas, or other mineral royalty or lease" and, hence,

were not "securities" subject to statutory registration provisions, where nothing more than transfer of a leasehold right was involved and, since defendant was attempting to transfer its entire interest and, upon sale, would have entirely removed itself from enterprise, situation was not one where parties were entering into a common venture dependent for success upon providing of capital by buyer and management by seller.

Affirmed.

1. Securities Regulation

In determining the existence of a "security" within the federal securities laws, the court should apply a flexible rather than a static principle, one capable of adaptation to meet the countless and variable schemes devised by those who seek to promote the use of others' money on the promise of or holding out of profit. Securities Act of 1933, § 2(1), 15 U.S.C.A. § 77b(1); Securities Exchange Act of 1934, § 3(a)(1, 10), 15 U.S.C.A. § 78c(a)(1, 10).

2. Securities Regulation

The definitions of sale and of security are to be liberally construed under the federal securities laws, but the courts must refrain from laying down any hard and fast rules as to what constitutes a security and, instead, look to the substance rather than the form of the transaction in making a case by case determination. Securities Act of 1933, §2(1), 15 U.S.C.A. § 77b(1); Securities Exchange Act of 1934, § 3(a)(1, 10), 15 U.S.C.A. § 78c(a)(1, 10).

3. Securities Regulation

An offering of fractional undivided interest in oil and gas leases is not a "public offering" requiring registration or invoking absolute liability for failure to register where whole transaction is a closely knit arrangement among friends and acquaintances, involving purchasers with sophisticated discernment about oil and gas business, and transaction is entered into after on-the-ground inspection and negotiation. Securities Act of 1933, § 2(1), 15 U.S.C.A. § 77b(1); Securities Exchange Act of 1934, §3(a)(1, 10), 15 U.S.C.A. § 78c(a) (1, 10).

4. Securities Regulation

Offers or sales of fractional interest in oil and gas leases to persons knowledgeable and experienced in such transactions, with whom the offeror has a long standing association in other leases, are transactions by an issuer not involving any public offering and, as such, are exempt from the absolute liability provisions of the Securities Act of 1933. Securities Act of 1933, § 12(2), 15 U.S.C.A. §§ 77d(a), 771(2).

5. Securities Regulation

Fractional working interests in two wells and lease units that defendant offered to sell plaintiff, when offered as a whole and not in further fractional interest, were not classifiable as an "investment contract" or as a "certificate of interest or participation in any oil, gas, or other mineral royalty or lease" and, hence, were not "securities" subject to statutory registration provisions,

where nothing more than transfer of a leasehold right was involved and, since defendant was attempting to transfer its entire interest and, upon sale, would have entirely removed itself from enterprise, situation was not one where parties were entering into a common venture dependent for success upon providing of capital by buyer and management by seller. Securities Act of 1933, § 2(1), 15 U.S.C.A. § 77b(1); Securities Exchange Act of 1934, § 3(a)(1, 10), 15 U.S.C.A. § 78c(a)(1, 10).

6. Securities Regulation

Issue whether a franchise agreement constitutes an investment contract and, hence, a security within registration provisions includes a consideration of nature of investor's financial and managerial participation in enterprise, state of investor's knowledge, skill, and expertise concerning enterprise, and whether investor is providing "risk capital" to finance a speculative venture. Securities Act of 1933, § 2(1), 15 U.S.C.A. § 77b(1); Securities Exchange Act of 1934, § 3(a)(1, 10), 15 U.S.C.A. § 78c(a)(1, 10).

7. Securities Regulation; Statutes

Provisions of Securities Act of 1933 are to be read as being in pari materia with provisions of Securities Exchange Act of 1934 and, hence, word "security" in both Acts is to be read as covering similar interests. Securities Act of 1933, § 2(1), 15 U.S.C.A. § 77b(1); Securities Exchange Act of 1934, § 3(a)(1, 10), 15 U.S.C.A. § 78c(a)(1, 10).

8. Fraud; Mines and Minerals

There was substantial evidence in record to support findings that plaintiff was not guilty of fraud, actual or constructive, in respect to its contract to sell fractional working interests in oil and gas leases to defendant, that there was no mutual mistake of fact existing between parties when contract was entered into, that plaintiff was under no affirmative duty to disclose subsequent adverse data it had secured after contract was entered into, and that defendant chose not to exercise its right of inquiring of plaintiff for "additional information and data" as set forth in brochures, but elected to rely on information obtained by its "in house" staff and its consulting expert.

William R. Fishman, Denver, Colo. (David H. Drennen, Denver, Colo., on the brief), for appellants.

Jeffrey L. Smith, Denver, Colo. (Marshall W. Taylor, Denver, Colo., on the brief), of counsel; Seawell, Cohen & Sachs, Denver, Colo., for appellees.

Before McWILLIAMS, BREITENSTEIN and BARRETT, Circuit Judges.

BARRETT, Circuit Judge.

Zoller & Danneberg Exploration, Ltd. and Zoller & Danneberg, Inc., defendants and counterclaimants below, hereinafter collectively referred to as ZDI, appeal from two orders of the District Court, to-wit: (1) the order of October 9, 1974, dismissing certain affirmative defenses and counterclaims of ZDI alleged to arise under § 12(2) of the Securities Act of 1933 and § 10(b) of the Securities Exchange

Act of 1934 and Rule 10b-5 promulgated thereunder, and (2) the order and judgment of October 22, 1975, granted in favor of appellee, Ballard & Cordell Corporation, hereinafter referred to as B&C, and against ZDI in amount of $63,473.75 and costs and dismissing with prejudice ZDI counterclaims against B&C, Wiley P. Ballard, Jr. and Robert R. Durkee. Jurisdiction exists by reason of diversity of citizenship. B&C is incorporated under the laws of and maintains its principal place of business in Georgia. ZDI are incorporated under the laws of and maintains its principal offices and places of business in Colorado.

Trial was to the court. B&C initiated the action in 1973, alleging that it contracted with ZDI to sell its 50% working interests in certain oil and gas lease units relating to lands situate in the State of Oklahoma with two producing oil wells located thereon, one on each of the said two lease units, for the sum of $105,000.00. B&C contends that it has, at all times since entering into the contract, been ready, willing, and able to perform its covenant to sell but that ZDI has breached the contract and damaged B&C by reason of its refusal to purchase. In its basic defense to the suit, ZDI denies the existence of a valid, enforceable contract. Seven affirmative defenses were advanced, together with a three-count counterclaim.

A somewhat detailed review of the evidence is necessary to aid in our disposition of the contentions presented. We proceed with this review mindful that the appellate court must view the evidence in the light most favorable to the pre-

vailing party and must affirm the trial court findings and conclusions unless they are clearly erroneous. Fed.Rules Civ.Proc. Rule 52, 28 U.S.C.A.; Garcia v. Gray, 507 F.2d 539 (10th Cir. 1974), cert. denied, 421 U.S. 971, 95 S.Ct. 1967, 44 L.Ed.2d 462 (1975); Scaramucci v. Dresser Industries, Inc., 427 F.2d 1309 (10th Cir. 1970).

ZDI were engaged primarily in the business of oil and gas exploration, commencing about March of 1969, during which time ZDI operated wells, participated in drilling operations and acquired oil and gas properties, including producing acreage. Henry Eugene Zoller, Jr. (Zoller, Jr.) served as president of both corporations (ZDI) during the times here involved. His professional background was that of a geological engineer. During the months of August and September, 1972, ZDI had "in house" technical staff which included engineers, petroleum engineers, petroleum geologists, accountants and landmen.

On December 4, 1970, ZDI received an offer from Texas Oil and Gas Corporation to acquire a 25% working interest in the "Adams Unit," one of the two wells here involved. ZDI acquired the interest and participated in the drilling of the Adams well on a joint venture basis with Texas Oil and Gas and B&C. ZDI had entered into many "deals" with Texas Oil and Gas of like nature prior thereto.

An offer was made by B&C in August of 1972 via brochures and an accompanying letter for the sale of its entire 50 percent working interest in two producing wells and the respective leasehold units, to-wit, Adams No. 1 and Eversole No. 1.

The brochures were distributed to those engaged in similar enterprises. The brochures clearly stated that the information and data related therein was preliminary only and that any interested purchaser should seek additional information and data from B&C offices. As previously noted, ZDI was then the owner of a 25% working interest in Adams No. 1 and its lease unit. ZDI undertook negotations with B&C for the purchase of B&C's interests. Zoller, Jr. played a "direct role, actually, in controlling the people who negotiated with their engineers." [R., Vol. I, p. 83]. He testified that after the brochures were received ". . . we went to work immediately evaluating them. . . we were attempting to get updated information because we felt that the information we had was extremely out of date." [R., Vol. I, p. 84]. Zoller, Jr. did not recollect that any specific request was made of B&C for updated information. He testified that a purchaser of any oil or gas well has risk in relation to unknowns and for that reason ZDI spent a great deal of time getting updated information on the wells. To this end, Zoller, Jr. employed for ZDI an "outside" consultant, one Norman Adams, to "evaluate the two wells along with our in-house petroleum engineer, Mr. Lueck." [R., Vol. I, p. 87]. Adams and Lueck conducted an investigation. They made numerous telephone calls. Zoller, Jr. testified that he was made aware of reserve estimates relating to both wells supplied to B&C by Kiplinger (sic) & Associates, dated March 1, 1971, and March 1, 1972, and that Norman Adams made a similar report and estimate for ZDI. Adams' evaluation report was not submitted to B&C. Mr. Lueck, who had

earned B.S. and M.S. degrees in petroleum engineering and who had worked for Continental Oil Company nine years and for King Resources three years, testified that his particular expertise employed with ZDI involved all aspects of production and operations; that he was very familiar with the procedures utilized by petroleum engineers in estimating recoverable reserves; that the most accepted method is to plot pressure versus cumulative production; that the fair market value of a producing property is directly related to the estimate of reserves; that he and Norman Adams, the independent consultant, were directed by ZDI to evaluate the Adams and Eversole wells; that the only pressure data that he and Adams reviewed and relied upon for evaluation purposes was the "initial" pressure data which did not reflect the substantially lower pressure data obtained by B&C and Texas Oil and Gas prior to recommendation that ZDI submit that which he and Adams believed to be a reasonable purchase offer for the B&C interests in the two wells and lease units, in amount of $105,000.00. This offer was tendered by ZDI via a telegram to B&C on September 8, 1972, subject only to delivery of merchantable title, said purchase to be effective October 1, 1972. The telegram was confirmed on a follow-up basis by a letter from ZDI to B&C on September 12, 1972. B&C evidenced acceptance by tendering the lease assignments on September 26, 1972. The lease assignments were acknowledged as correct and proper in a letter from ZDI requesting that prior to payment ZDI needed additional abstracts of title, additional title information on the Adams well-lease unit, title opinions and supplemental abstracts relative to the Eversole well-lease unit,

and a bill of sale and inventories of equipment on the units being sold. All but a portion of the title material was thereafter supplied by B&C. There was considerable discussion and correspondence between the parties and attorneys relating to title requirements. On December 15, 1972, ZDI wrote B&C advising that it was withdrawing the offer to purchase because of delays in supplying title information and the fact that the "title to your interest in the above units is not merchantable. . ."

The trial court found that, (a) although merchantable title had not been furnished by B&C at the date of ZDI's withdrawal of the offer to purchase, that the outstanding title defects could have been adequately corrected by B&C, (b) from September of 1972 to December 15, 1972, the production and well pressure information and data relating to Adams No. 1 well reflected a decline, and that this information was available to ZDI as an owner of a working interest in the well, (c) ZDI attempted to terminate the contract of purchase by its letter of December 15, 1972, because of the decline in production and pressure as to Adams No. 1 well and not because of B&C's failure at that time to have furnished full merchantable title to the two units. The trial court placed substantial reliance for its finding set forth in (c) above on the fact that in January, 1973, Texas Oil and Gas Corporation, the operator, recommended to all parties in interest, including ZDI, that Adams No. 1 well be plugged and abandoned because it was no longer commercially feasible to continue its operation, based upon the decline in production and pressure data reflected

in a report filed with the State of Oklahoma early in November of 1972. The court further found that ZDI did not terminate the agreement because of title deficiencies, as evidenced by an agreement between B&C and ZDI to expend funds as late as May of 1973 to rework the Adams No. 1 well in the hope of increasing its production. The trial court found that the "declining production and pressure of the Adams well prior to December 15, 1972, and May, 1973, support a finding that the defendant attempted to terminate the contract because it turned out to be a bad deal and not because of title insufficiencies." We agree.

I.

ZDI contends that the trial court's 1974 order striking certain affirmative defenses and dismissing two counts of ZDI counterclaims, was clearly erroneous as a matter of law and fact. The trial court held that the 50 percent working interests in the two properties offered for sale by B&C were not "securities" as that term is defined in § 2(1) of the Securities Act of 1933 and § 3(a)(1) of the Securities Exchange Act of 1934. We agree.

The term "security" is defined in § 2(1) of the Securities Act of 1933 to include any "investment contract," any "fractional undivided interest in oil, gas, or other mineral rights," and any "certificate of interest or participation in any profit-sharing agreement." 15 U.S.C.A. § 77b(1). The term "security" as defined under the Securities and Exchange Act of 1934 includes any "certificate of interest or participation in

any profit-sharing agreement or . . . in any oil, gas, or other mineral royalty or lease" and any "investment contract," 15 U.S.C.A. § 78c(a)(10).

We emphasize, just as did the trial court, that the fifty percent working interests in the two wells and lease units offered for sale by B&C, while a fractional interest, were offered as a whole and not in further fractional interests.

This Court has adhered to this rule laid down in S.E.C. v. Howey Co., 328 U.S. 293, 66 S.Ct. 1100, 90 L.Ed. 1244 (1946): That in determining the existence of a "security" the court should apply a flexible rather than a static principle, one capable of adaptation to meet the countless and variable schemes devised by those who seek to promote the use of others' money on the promise of or holding out of profit. Stevens v. Vowell, 343 F.2d 374 (10th Cir. 1965). See also: Hadsell v. Hoover, 484 F.2d 123 (10th Cir. 1973); Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90 (10th Cir. 1971), cert. denied, 404 U.S. 1004, 92 S.Ct. 564, 30 L.Ed.2d 558 (1971). This principle is in keeping with the broad remedial policies of the federal securities laws. J. I. Case Co. v. Borak, 377 U.S. 426, 84 S.Ct. 1555, 12 L.Ed.2d 423 (1964). While the definitions of sale and of security are to be liberally construed under the federal securities laws, still the courts have refrained from laying down any hard and fast rules as to what constitutes a security, and, instead, look to the substance rather than the form of the transaction in making a case-by-case determination.

In Woodward v. Wright, 266 F.2d 108 (10th Cir. 1959), this Court recognized

that although the legislative policy in the Securities Act of 1933 was to bring all "securities" within the regulatory scope of the Act without regard to form or legal terminology, such does not render every transaction involving the sale of a fractional interest in oil, gas, or other mineral rights, ipso facto, the sale of a security. We there held that it was the manifest Congressional intent to exclude from the scope of the Act isolated sales or assignments of oil and gas leases or fractional parts thereof to specific persons, and to specifically include as securities only that form of splitting up of mineral interests which had been most utilized for speculative purposes, citing to S.E.C. v. C. M. Joiner Leasing Corp., 320 U.S. 344, 64 S.Ct. 120 88 L.Ed. 88 (1943). Further, Woodward, supra, held that while the fractional undivided interests in oil and gas contemplated to be sold were created for purposes of sale and were, accordingly, "securities" within the meaning of the Act, still the offering was not a "public offering" under the Act requiring registration or invoking the absolute liability for failure to register because: (a) the whole transaction was a closely-knit arrangement among friends and acquaintances, involving purchasers with sophisticated discernment about the oil and gas business, and (b) the transaction was entered into after on-the-ground inspection and negotiation. Even though the transaction was not subject to the registration provisions of the Act and even though the seller was not an "issuer" under the Act, still we held that the purchasers were entitled to invoke § 12(2) of the Act, 15 U.S.C. § 771(2), which creates a remedy for rescission or damages against

any person who uses any means of interstate commerce or the mails to sell a security by means of a prospectus or oral statement which includes an untrue statement of a material fact or omits to state a material fact. Woodward, supra, further stands for the proposition that characterization of a "public offering" does not turn on the number of persons to whom the offer is made and it may be applicable to a few or many, citing to S.E.C. v. Ralston Purina Co., 346 U.S. 119, 73 S.Ct. 981, 97 L.Ed. 1494 (1953). Accord: Nor-Tex Agencies, Inc. v. Jones, 482 F.2d 1093 (5th Cir. 1973), cert. denied, 415 U.S. 977, 94 S.Ct. 1563, 39 L.Ed.2d 873 (1974).

Particularly significant to the case at bar is Gilbert v. Nixon, 429 F.2d 348 (10th Cir. 1970) which involved an action for damages by the purchaser of fractional interests in thirteen oil and gas leases. We affirmed the District Court's findings and conclusions that: (1) the fractional interests were "securities" within the meaning of 15 U.S.C.A. § 77b(1) and 15 U.S.C.A. § 78c(a)(10); (2) offers or sales of fractional interests in oil and gas leases to persons knowledgeable and experienced in such transactions, with whom the offeror had a long standing association in other leases were "transactions by an issuer not involving any public offering" as provided in 15 U.S.C.A. § 77d(2), and thus were exempt from the absolute liability provisions of the Act; and (3) that there is no need under 15 U.S.C.A. § 771(2) for a seller of a fractional interest to state every fact which, if known to the prospective purchaser, might tend to influence his decision. We cited favorably to Woodward v. Wright, supra,

for the proposition that the fractional interests sold in Gilbert were "transactions by an issuer not involving any public offering." See also Garfield v. Strain, 320 F.2d 116 (10th Cir. 1963).

ZDI further contends that the District Court erred in finding that the sale of B&C's entire undivided interest in the two wells and lease units did not involve an "investment contract" and, therefore, a "security" under the federal securities acts. ZDI urges that the economic reality of this case is that ZDI was called upon to determine whether to make an investment and that inasmuch as all that was offered was a 50% working interest in two wells and lease units, with no additional acreage to be drilled, all that ZDI could be acquiring via the investment was "an interest in producing gas wells or, more precisely, an interest in the existing gas reserves." [Brief of ZDI, p. 20.] ZDI states that under these circumstances, it was relying solely upon the production from those reserves in order to obtain a return on its investment plus a profit.

The trial court recognized that the sale of an entire interest may involve an "investment contract" constituting a "security," citing to Lynn v. Caraway, 379 F.2d 943 (5th Cir. 1967), cert. denied, 393 U.S. 951, 89 S.Ct. 373, 21 L.Ed.2d 362 (1968). The court further cited S.E.C. v. Howey Co., supra, for the rule that the test for determining whether a particular transaction constitutes an investment contract is "whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others." 328 U.S., at 301, 66 S.Ct. at 1104. But, rules

the trial court, an investment contract must transfer more than a "naked leasehold right" and usually involves additional economic inducements, relying upon S.E.C. v. C. M. Joiner Leasing Corp., supra, and Roe v. United States, 287 F.2d 435 (5th Cir. 1961), cert. denied, 368 U.S. 824, 82 S.Ct. 43, 7 L.Ed.2d 29 (1961). The trial court further relied upon Mr. Steak v. River City Steak, Inc., 460 F.2d 666 (10th Cir. 1972) which quoted with approval Judge Arraj's opinion reported at 324 F.Supp. 640 (D.Colo.1970) for the proposition that the instant case does not involve an investment contract. By analogy, the Court observed that Mr. Steak, supra, involved a franchise agreement wherein the franchisor retained extensive supervisory authority and the franchisee was given control of the daily operations of the business. In holding that the agreement did not constitute an investment contract, this Court considered several important factors, including the nature of the investor's financial and managerial participation in the enterprise; the state of the investor's knowledge, skill, and expertise concerning the enterprise; and whether the investor is providing "risk capital" to finance a speculative venture. We agree with the trial court's analysis that no investment contract is involved in the case at bar:

> The present case appears to involve nothing more than the transfer of a leasehold right. Since [B&C] was attempting to transfer its entire interest and, upon sale would have entirely removed from the enterprise, this is not a situation where the seller and buyer were entering into

> a common venture dependent for success upon the providing of capital by the buyer and management by the seller. The common enterprise, if any, existed between [ZDI] and Texas Oil and Gas Corp., the independent operator of the wells.
>
> [ZDI] were indeed relying on the efforts of the independent operator and the question is whether they were relying solely on the efforts of the operator, as required by the Howey test. The terms of the operating agreement gave [ZDI] limited participation in the operation of the wells. [ZDI] were required to pay a stated percentage of the costs of operation, but could withhold consent for the incurrence of operating expenses in excess of $5,000, for the drilling of new wells on the unit area, and for the reworking, plugging back or deepening of any existing wells . . . in the event of non-agreement . . . a dissenting party can elect not to participate in the proposed operation . . . [ZDI] can also participate in the selection of a new operator, should the present operator sell his rights . . . Most investment contract cases involve the financing of speculative and poorly financed schemes by soliciting funds from uninformed and unskilled investors. . . [ZDI] are far from being uninformed or unskilled in the type of venture involved. It appears that [ZDI's] activities are concentrated in oil and gas production and exploration. Also, there is no indication that the enterprise was poorly financed, and the fact

that the wells were producing negates the speculative nature of the lease. The attendant risk seems to be merely a normal risk of engaging in this type of business. Therefore, under the Mr. Steak, Inc. analysis, the present facts do not give rise to an investment contract. R., Vol. X, pp. 120-122.

The trial court furthermore properly disposed of ZDI's contention that B&C was offering for sale a security under the 1934 Act in the form of a "certificate of interest or participation in any oil, gas, or other mineral royalty or lease" as set forth in 15 U.S.C.A. § 78c(a)(10). The court held that the term "security" is not to be defined differently under the 1934 Act than under the 1933 Act, inasmuch as the acts are to be considered in pari materia, both intended to cover similar interests. Tcherepnin v. Knight, 389 U.S. 332, 88 S.Ct. 548, 19 L.Ed.2d 564 (1967); Mr. Steak, Inc. v. River City Steak, Inc., supra; Wasnowic v. Chicago Board of Trade, 352 F.Supp. 1066 (M.D. Pa. 1972); Anderson v. Francis I. duPont & Co., 291 F.Supp. 705 (D. Minn. 1968).

The court did not err in granting B&C's motion to dismiss the sixth and seventh affirmative defenses and counts I and II of the ZDI counterclaim, and in denying B&C's motion to dismiss or for summary judgment on ZDI's fifth affirmative defense and count III of the counterclaim based on allegations of common law fraud.

II.

ZDI appeals the final judgment entered

in accordance with the trial court's Findings of Fact and Conclusions of Law, dated October 22, 1975, where by (sic) B&C was awarded judgment against ZDI in amount of $63,473.75 and costs.

ZDI contends that the court erred in allowing B&C judgment because (a) B&C was guilty of common law fraud and deceit in its dealings with ZDI in that B&C did not relate to ZDI the information it had in its possession relative to the well pressure, (b) that B&C had a duty to convey to ZDI the new material adverse information regarding the wells, i.e., the data it had received from Texas Oil and Gas Corp. and B&C's expert, Kiplinger (sic), relative to diminished well pressures indicative that the wells were practically non-productive at the time of purchase, (c) that the court's findings that ZDI was not misled by B&C's failure to reveal the July, 1972, gas pressure report and that the withholding was without intent to defraud is clearly erroneous, (d) that the court's finding that the decline in pressure which occurred between September and December, 1972, was information available to ZDI was clearly erroneous, (e) ZDI was entitled to rescind the contract because its consent thereto was not freely given and (f) any contract between the parties was unenforceable because B&C did not deliver merchantable title and could not do so within the time permitted by the contract for correction of deficiencies of title. We hold that the trial court did not err.

There is substantial evidence in the record supporting the trial court's finding of fact that the ZDI attempt to terminate the purchase contract via its

letter of December 15, 1972, was based upon its knowledge of the declining production and gas pressure relating to Adams No. 1 well and not because of B&C's failure at that time to have furnished evidence of marketable title. We have heretofore discussed in some detail the material facts supporting the above finding.

In disposing of the ZDI allegation that B&C was guilty of common law fraud, we concur with the trial court's finding that B&C was not under a duty to voluntarily disclose adverse pressure data reported by its expert to ZDI as a prospective purchaser and that in the oil and gas industry such evaluations are not customarily exchanged between a prospective seller and prospective purchaser. The trial court properly found that B&C obtained the expert engineering report of the Kiplinger (sic) firm in August, 1972, which was based in part on information from Texas Oil and Gas Corp. that a shut-in tubing pressure test of July, 1972, indicated pressure of 960 p.s.i., which was considered by Kiplinger (sic) when it reported to B&C that neither of the two wells would last much longer; that while the 960 p.s.i. was apparently erroneous because the correct pressure for Adams was 900 p.s.i. in May, 1972, and 625 p.s.i. in July, 1972, still the 960 p.s.i. was reported by error, which was not then known to be the case by B&C. ZDI contends that the lower and accurate figure was critical information to which it was entitled. The trial court properly found that there is no evidence that B&C was informed of the 625 p.s.i. test made in July of 1972. Insofar as B&C's obligation to ZDI is concerned, the court referred back to that portion of the

original brochures which initiated the negotations. The court placed particular emphasis upon the proviso under the heading of "Purpose" which reads:

> The purpose of this report is to provide the information necessary for a preliminary evaluation . . . additional information and documentation for the data presented here may be inspected in the offices of the Ballard & Cordell Corporation in Lafayette, Louisiana.

The trial court found that ZDI did not seek additional information and documentation from B&C, but instead employed its own consulting engineer in the person of Norman Adams, to make an independent evaluation of the wells in conjunction with its Mr. Lueck; that Adams thereafter made his own investigation, including an inquiry of the Texas Oil and Gas Corp. for pressure and production information; that for some undisclosed reason, Texas Oil and Gas Corp. did not report to Adams the July, 1972, pressure of 960 p.s.i. which appeared in its records but that B&C was not aware of this fact; that B&C's failure to reveal to ZDI the apparently erroneous pressure report submitted to it by Texas Oil and Gas Corp. relative to the status of the Adams well in July of 1972, coupled with the adverse report by Kiplinger (sic), was not done with intent to defraud; that B&C was not obliged to disclose an expression of opinion of an expert it employed to ZDI as a prospective purchaser in the norm of the day-to-day practice in the oil and gas industry, evidenced by the fact that ZDI did not submit to B&C the evaluation of the wells made by its expert, Adams; that

there is no evidence which would impose a duty on either B&C or ZDI to disclose the opinions of their respective experts; and that B&C did not at any time make any misrepresentations of material fact to ZDI. We concur. These findings are not clearly erroneous.

We further concur with the trial court findings that there is substantial evidence demonstrating that B&C was not guilty of fraud, actual or constructive; that there was no mutual mistake of fact existing between the parties when the contract was entered into; that B&C was under no affirmative duty to disclose subsequent adverse data it had secured after the contract was entered into; that ZDI chose not to exercise its contract right of inquiring of B&C for "additional information and data" as set forth in the brochures but elected to rely on information obtained by its "in house" staff and its consulting expert, Mr. Adams.

We have carefully considered the balance of ZDI counterclaims, defenses, or contentions. We hold that they are without merit.

WE AFFIRM.

APPENDIX "D"

NOVEMBER TERM - December 13, 1976

Before The Honorable David T. Lewis,
Chief Judge
The Honorable Jean S. Breitenstein,
Senior Judge
The Honorable Delmas C. Hill,
The Honorable Oliver Seth,
The Honorable William J. Holloway, Jr.,
The Honorable Robert H. McWilliams,
The Honorable James E. Barrett and
The Honorable William E. Doyle,
Circuit Judges

THE BALLARD AND CORDELL CORPORATION,
Plaintiff-Appellee,
vs.
ZOLLER & DANNEBERG EXPLORATION, LTD.;
ZOLLER & DANNEBERG, INC.,
Defendants-Counter-
Plaintiffs-Appellants,
vs. No.75-1900
THE BALLARD & CORDELL CORPORATION,
WILEY P. BALLARD, JR.,
ROBERT R. DURKEE,
Counter-Defendants-
Appellees.

This matter comes on for consideration of the appellants' petition for rehearing and suggestion for rehearing en banc in the captioned cause.

Upon consideration whereof, the petition for rehearing is denied by Circuit Judges McWilliams, Breitenstein and Barrett to whom the case was argued and submitted.

The petition for rehearing having

been denied by the original panel to whom the case was argued and submitted and no member of the panel nor judge in regular active service on the Court having requested that the Court be polled on rehearing en banc, Rule 35, Federal Rules of Appellate Procedure, the suggestion for rehearing en banc is denied.

/s/ Howard K. Phillips
HOWARD K. PHILLIPS
Clerk

Supreme Court, U. S.
FILED
MAY 18 1977
MICHAEL RODAK, JR., CLERK

In the

Supreme Court of the United States

October Term, 1976

No. 76-1165

ZOLLER & DANNEBERG EXPLORATION, LTD. AND ZOLLER & DANNEBERG, INC.
Petitioners,

vs.

THE BALLARD & CORDELL CORPORATION,
Respondent.

BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

JEFFREY L. SMITH
Counsel for Respondent
1518 Lincoln Center Building
1660 Lincoln Street
Denver, Colorado 80264

Of Counsel
SEAWELL & COHEN
Professional Corporation
1518 Lincoln Center Building
1660 Lincoln Street
Denver, Colorado 80264

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STATEMENT OF THE CASE

The Ballard & Cordell Corporation ("B&C") supplements Petitioners' Statement of the Case as follows. (Zoller & Danneberg Exploration, Ltd., and Zoller & Danneberg, Inc., shall be collectively referred to herein as "ZDI".)

ZDI had extensive experience and expertise in the oil and gas industry. It had engaged in exploration, drilling, operating wells, and acquiring oil and gas properties, including producing properties, such as the two wells involved in this transaction. ZDI had a complete staff of technical people, including petroleum engineers, petroleum geologists, accountants, and landmen, and regularly used an independent petroleum consultant. The two wells ZDI sought to acquire from B&C were operated by Texas Oil and Gas Corporation ("Texas"). In the past, ZDI had participated in a number of drilling deals with Texas, and in fact had acquired the 25% working interest it already held in one of the two wells by participating in the original drilling of that well with Texas. (Petitioners' Appendix C, p. vii)

In connection with offering the sale of its 50% working interest in the two wells, B&C mailed brochures to ZDI. These brochures specifically advised all interested purchasers that the data and information was for preliminary evaluation only and recommended that interested purchasers contact B&C for additional data and information. ZDI never contacted B&C, instead relying upon its own in-house technical staff and its own independent petroleum consultant to gather pertinent data and information from the operator, Texas. (Petitioners' Appendix B, p. ix; Petitioners' Appendix C, pp. viii and xxi)

Both the independent petroleum consultant for B&C and the independent petroleum consultant for ZDI separately sought current well data from Texas. For reasons which were never determined at trial, Texas supplied

B&C's consultant with pressure data which it neglected to supply to ZDI's consultant. However, the well pressure data which was supplied to B&C's consultant and which was utilized in formulating the opinion he rendered B&C was wrong. (Petitioners' Appendix B, pp. ix-x; Petitioners' Appendix C, p. xx)

The independent petroleum consultants of both B&C and ZDI prepared reservoir evaluations of the two wells for their respective clients. ZDI complains herein of the failure of B&C to disclose to ZDI the evaluation of its consultant; however, as a prospective purchaser, ZDI failed to disclose to B&C the evaluation of its consultant. (Petitioners' Appendix B, p. xi; Petitioners' Appendix C, p. xx) Moreover, the practice of the industry in buying and selling producing property is to not disclose these opinions in transaction between oil and gas companies. (Petitioners' Appendix B, p. xi; Petitioners' Appendix C, p. xx)

The trial court struck Petitioners' anti-fraud claims under the Securities Act of 1933 ("1933 Act") and the Securities Exchange Act of 1934 ("1934 Act"); however, the trial court did consider the same claims under common law fraud and ruled against Petitioners on the merits (Petitioners' Appendix B, pp. viii-xi), which conclusion was affirmed by the court of appeals. (Petitioners' Appendix C, p. xxii)

SUMMARY OF ARGUMENT

This case does not present the considerations set forth in Rule 19 of this Court's Rules for granting a review on writ of certiorari. The decisions of the trial court and court of appeals are: (1) consistent with the opinions of the three courts of appeals which have considered the transfer of working interests in oil and gas wells; (2) consistent with the regulatory purpose of the securities laws; and (3) consistent with the decisions of other courts of appeals which have considered the investment contract issue.

ARGUMENT

(1) B&C owned undivided 50% working interests in two producing wells which it contracted to sell to ZDI. Consummation of the sale to ZDI would have resulted in the transfer of B&C's entire interest in both wells. Prior to the purchase and sale agreement, ZDI already owned an undivided 25% working interest in one of the two wells. Both companies had extensive experience and available expertise in all phases of the oil and gas industry. Prior to the decision under consideration herein, three courts of appeals have concluded that under factual settings similar to the one under consideration herein, the sale of the entire working interest, even if it has been previously fractionalized, does not constitute the sale of a security. *Lynn v. Caraway,* 252 F. Supp. 858 (W.D. La. 1966), *aff'd,* 379 F.2d 943 (5th Cir. 1967), *cert. denied* 393 U.S. 951 (1968); *Graham v. Clark,* 332 F.2d 115 (6th Cir. 1964); *Woodward v. Wright,* 266 F.2d 108 (10th Cir. 1959). No court of appeals has ruled to the contrary, and review by writ of certiorari is not indicated.

Woodward v. Wright, supra, involved the sale of a 15/16th working interest in a producing well to four purchasers. The sale contract clearly contemplated the splitting of that interest among the four purchasers. Relying upon this Court's reasoning in *S.E.C. v. Joiner Leasing Corp.,* 320 U.S. 344 (1943), the court of appeals concluded that Congress did not intend to bring the sale of all oil and gas leases and fractional parts thereof under the scope of the securities statutes, but only those patterns of splitting which were utilized to raise the money for speculative purposes. Accordingly, the court of appeals held that if the owner transfers the whole of what he owns, there is no creation of a fractional undivided interest, even though the interest he has sold represents something less than the entire well. Conversely, the court held that because Wright split the working interest among a number of purchasers, he created a

security in the form of fractional undivided interests in oil and gas rights.

In *Graham v. Clark, supra,* the defendants sold all of their lease interest in acreage upon which wells were producing. The court of appeals held that because defendants sold their entire working interest, the transaction did not constitute the sale of a security.

Lynn v. Caraway, supra, involved an action against Jones, an owner-operator, and Allison, a lease broker. Pursuant to a sale agreement, Jones purchased the fractional interests in a producing well from his co-owners and sold the entire unit to Allison. Allison, in turn, split the unit and sold fractional interests therein to a number of purchasers. The court held that Jones was not liable under the registration and anti-fraud provisions of the 1933 Act because he did not offer or sell a security. Allison, however, was held to have sold a security.

The decision of the court of appeals in this case is in accord with the decisions of all of the courts of appeals which have considered this question. Petitioners argue that the reasoning of these courts would result in the conclusion that had B&C sold its 50% working interest to ZDI and Exxon, the sale would have constituted the sale of a security. These are not the facts which were presented below, and under the facts presented to this Court in Petitioners' Petition for Writ of Certiorari, the conclusion of the court of appeals is proper.

(2) Petitioners argue for a "liberal" construction of the definition of a security. A liberal construction does not necessarily lead to the conclusion that a transaction involves the sale of a security. Courts, including this Court, have looked to the economic substance of the transaction rather than its form in order to accomplish the purposes intended by Congress. This process not only places transactions within the scope of the securities statutes which, by their form,

appear beyond these statues, but places beyond the scope of these statutes transactions which, by their form, appear to be within their scope. Two areas of securities litigation which offer a sound demonstration of this process are a number of recent decisions by courts of appeals involving arguments that notes are securities, and this Court's treatment of stock sold in connection with low-income cooperative housing in *United Housing Foundation v. Forman,* 421 U.S. 837 (1975).

Both the 1933 Act and the 1934 Act provide, in part, "[t]he term 'security' means any note . . . ." Applied literally, all notes would be securities, which would result in the application of the regulatory process and remedies to transactions far beyond the abuses Congress sought to remedy. The courts have generally resisted a literal application, electing instead to gauge each transaction to the abuses Congress sought to correct.

In *Zabriskie v. Lewis,* 507 F.2d 546 (10th Cir. 1974) Mrs. Zabriskie had engaged Lewis to locate investments for her, who in turn had introduced her to Worthen. In a series of transactions, Mrs. Zabriskie loaned money to Worthen to be utilized in promoting a corporation in exchange for promissory notes. The decision of the court of appeals considers two initial points well established: first, not all notes are securities despite the wording of the statutes; and second, despite the fact that the 1934 Act excludes from the scope of its definition notes with a maturity date of less than nine months, such notes may in fact be a security. The court observed that the test in determining whether a note is or is not a security is based upon the purpose of the 1933 and 1934 Acts to protect investors and the practical consideration of subjecting commercial notes to the registration requirements and subjecting the federal courts to the anti-fraud litigation that would ensue. The court, in concluding that Mrs. Zabriskie's notes constituted the sale of securities,

relied upon the fact that she had been seeking investments, that she was an unsophisticated investor, that she was not ordinarily in the business of making loans, that she had been advised her funds would be used to promote a corporation, and that she was promised 120% return on her money.

In *Bellah v. First National Bank of Hereford, Texas,* 495 F.2d 1109 (5th Cir. 1974), plaintiffs executed a promissory note in connection with their livestock business, which note was secured by a deed of trust and renewed several times thereafter. Plaintiffs alleged misreprsentations in connection with renewal of the note and sought relief under Section 10(b) of the 1934 Act and Rule 10b-5 promulgated thereunder. The court, in analyzing the transaction, distinguishes transactions involving commercial paper and those involving investment paper, concluding that in this case the transaction was a commercial transaction and that it accordingly did not constitute the sale of a security. The court considered its conclusion that commercial paper transactions were beyond the scope of the 1934 Act buttressed by the observation that a contrary view would subject all such transactions to possible registration requirements and subject the courts to a substantial increase in anti-fraud litigation under the securities statutes.

In *S.E.C. v. Continental Commodities Corp.,* 497 F.2d 516 (5th Cir. 1974), Continental Commodities' option trading was suspended. Thereafter Continental Commodities issued promissory notes to its customers in partial reimbursement for their discretionary trading accounts. The court concluded, after examining the transaction, that the notes were not issued in connection with liquidation of the enterprise, but with the intent of retaining the customers' money and rejuvenating the enterprise. The court, accordingly, held the notes constituted the sale of a security.

In each of the foregoing promissory note cases, and in the many other note cases which have been recently decided, the courts have elected to ignore the literal definition, choosing instead to examine each transaction in an effort to determine whether the transaction, regardless of its name, falls within the scope of the abuses Congress sought to correct.

United Housing Foundation v. Forman, supra, involved a low-income housing cooperative. In connection with apartment rentals, Riverbay Corporation offered "stock" to all tenants, the amount of stock issued being determined by the number of rooms the particular tenant leased. The issued stock was tied to each apartment and transfer to non-tenants was prohibited. The stock carried none of the rights normally associated with stock, such as voting rights. Participation in cooperative affairs was determined by the number of residents in an apartment unit, not the number of shares of stock held. At termination of occupancy, a tenant was required to offer the stock to Riverbay at the tenant's initial purchase price. The stock was in fact a rental deposit. During construction, Riverbay circulated an information bulletin to prospective tenants. The bulletin estimated the rental rates of the apartment; however, because of increased construction costs, the rental rates ultimately charged were raised without disclosure in a subsequent information bulletin. A number of tenants sued under the anti-fraud provisions of the 1933 and 1934 Acts, seeking damages and rental reductions. The Court, in concluding the transaction did not involve the sale of a security, despite use of the term "stock," stated:

> "The primary purpose of the Acts of 1933 and 1934 was to eliminate serious abuses in a largely unregulated securities market. The focus of the Acts is on the capital market of the enterprise system: the sale of securities to raise capital for profit-making purposes, the exchanges on which securities are traded, and the need for regulation to prevent fraud and to protect

the interest of investors. Because securities transactions are economic in character Congress intended the application of these statutes to turn on the economic realities underlying a transaction and not on the name appended thereto." 421 U.S. at 849

In similar fashion, the 1933 Act provides, "[t]he term 'security' means . . . fractional undivided interest in oil, gas, or other mineral rights . . ." and the 1934 Act provides, "[t]he term 'security' means any . . . participation in any . . . oil, gas, or other mineral royalty or lease . . . ." The strict application of this definition would impose restrictions, create remedies, and increase federal anti-fraud litigation beyond that contemplated by Congress, and beyond the protection Congress intended to create. This Court in *S.E.C. v. Joiner Leasing Corp., supra,* stated:

"Oil and gas rights posed a difficult problem to the legislative draftsman. Such rights were notorious subjects of speculation and fraud, but leases and assignments were also indispensable instruments of legitimate oil exploration and production. To include leases and assignments by name might easily burden the oil industry by controls that were designed only for the traffic in securities. This was avoided by including specifically only that form of splitting up of mineral interests which had been most utilized for speculative purposes." 320 U.S. at 352.

The B&C sale to ZDI does not fall within the area of abuse referred to above and the abuses Congress sought to correct. The transaction involved the sale of producing property. Money was not sought by B&C for speculative purposes. ZDI's capital was not needed to promote a venture, and ZDI, accordingly, was not contributing risk capital. The wells were operated by a third party, Texas, and ZDI had equal access to any data and information it deemed pertinent, as well as the expertise to gather and

evaluate that data. In fact, the well which was eventually plugged, thereby precipitating the litigation herein, (see the trial court's Findings of Fact, Petitioners' Appendix B, p. vii) was 25% owned by ZDI prior to its negotiations with B&C.

The considerations involved in determining the existence of a security are analyzed in Coffey, *The Economic Realities of a "Security": Is There a More Meaningful Formula?,* 18 Western Reserve L. Rev. 367 (1967). The author suggests the following guidelines:

"A 'security' is:

(1) A transaction in which

(2) a person ('buyer') furnishes value ('initial value') to another ('seller'); and

(3) a portion of initial value is subjected to the risks of an enterprise, it being sufficient if—

(a) part of initial value is furnished for a proprietary interest in, or debt-holder claim against, the enterprise, or

(b) any property received by the buyer is committed to use by the enterprise, even though the buyer retains specific ownership of such property; or

(c) part of initial value is furnished for property whose present value is determined by taking into account the anticipated but unrealized success of the enterprise, even though the buyer has no legal relationship with the enterprise; and

(4) at the time of the transaction, the buyer is not familiar with the operations of the enter-

prise, or does not receive the right to participate in the management of the enterprise; and

(5) the furnishing of initial value is induced by the seller's promises or representations which give rise to a reasonable understanding that a valuable benefit of some kind, over and above initial value, will accrue to the buyer as a result of the operation of the enterprise." 18 Western Reserve L. Rev. at 377.

None of ZDI's "initial value" was subjected to the risks of the enterprise — it was not required for the enterprise, which was already operational. ZDI was equally familiar with the operations and upon completion of the transaction would have been the 50% working interest owner in one well and the 75% working interest owner in the other. The management participation afforded ZDI is more fully described in the next portion of this brief. Finally, Professor Coffey commences his definition by defining a security as a "transaction." This is of course consistent with the abuses Congress sought to correct. Petitioners' brief refers to the writings of several commentators in the securities field. The thrust of their discussions in criticizing *Woodward v. Wright, supra,* and the decisions which followed *Woodward,* is that once you create a security, it remains a security forever. This analysis focuses on the piece of paper rather than the underlying transaction. This analysis looks to the form rather than the substance. It is the transaction which must be examined in each instance, and the transaction presented to this Court in Petitioners' writ did not constitute the sale of a security.

(3) Upon completion of the sale to ZDI, ZDI would not have been looking to the essential management efforts of others for the success of the enterprise and, accordingly, the sale was not an investment contract.

The wells ZDI contracted to purchase were producing wells. To the extent management efforts affected the success of the enterprise, these efforts were expended at and before drilling. Moreover, the wells were operated by Texas. B&C would have retained no interest and ZDI would have held a 75% working interest in one and a 50% working interest in the other. To the extent managerial efforts affected the success of the operation, ZDI would have played, or had the right to play, a significant role in those efforts. ZDI had the right to complete access to the wells and the operator's books and records; had the right to control any extraordinary expenditures and the right to control the selection of any new operator. After ZDI refused to complete the contract to purchase B&C's interest in the two wells, it continued to hold a 25% working interest in the one well. As a 25% working interest owner, ZDI participated in the decision to rework that well and voluntarily contributed its proportionate share of the expenses required to rework the well. To the extent managerial efforts were required by anyone, ZDI was an active participant.

Petitioners argue that the Dare To Be Great litigation, *S.E.C. v. Glenn W. Turner Enterprises, Inc.,* 474 F.2d 476 (9th Cir. 1973), *cert. denied,* 414 U.S. 821 (1973); *S.E.C. v. Koscot Interplanetary, Inc.,* 497 F.2d 473 (5th Cir. 1974); *Miller v. Central Chinchilla Group, Inc.,* 494 F.2d 414 (8th Cir. 1974) has created a conflict among the courts of appeals as to the factors which determine the existence of an investment contract.

The facts in the Dare To Be Great litigation are considerably different than the facts in the present litigation. In that litigation it was argued that because the investor was not solely looking to the efforts of others, it was not an investment contract. The investor's participation was restricted to bringing a prospect to the sales meeting,

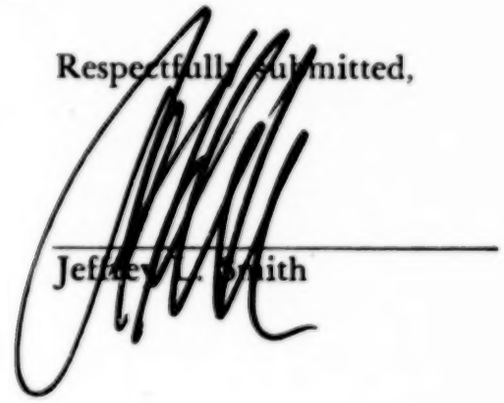
even being instructed against advising the prospect in advance of the nature of the meeting. The investor thereafter relied upon the efforts of others to generate the sales environment necessary to expand the pyramid. The courts ruled that although the investor was required to lend some participation, the undeniably significant efforts, those essential managerial efforts which affected the success or failure of the enterprise, were contributed by others.

These cases do not create a conflict among courts of appeals. Each court is careful to indicate that it does not intend to redefine the nature of a security. 474 F.2d at 483; 494 F.2d at 417; 497 F.2d at 483. Indeed, the court in *S.E.C. v. Koscot Interplanetary, Inc., supra,* reconciled its opinion with the opinions of the Tenth Circuit Court of Appeals. 497 F.2d at 481. There is very little difference between the investor's role in the Dare To Be Great litigation of bringing the next prospect in for a sales presentation and the opportunity afforded investors in *Continental Marketing Corp. v. S.E.C.,* 387 F.2d 466 (10th Cir. 1967), *cert. denied* 391 U.S. 905 (1968) to raise their own beavers. Petitioners are not entirely accurate in suggesting that the Tenth Circuit Court of Appeals absolutely requires that the investor depend *solely* upon the efforts of others.

CONCLUSION

The transaction Petitioners present to this Court for review did not involve the sale of a security. The trial court and court of appeals did, however, consider the merits of Petitioners' defense of fraud at common law, among many other defenses, and ruled in favor of Respondent. Petitioners assert that this Court must review the securities issues they have already unsuccessfully raised with two courts. The holding of the court of appeals is consistent with the securities decisions of this Court and the other courts of appeals and to adopt the position of Petitioners will substantially change the regulatory scheme and remedies of the oil and gas industry. Petitioners' Petition for Writ of Certiorari should be denied.

Respectfully submitted,



Jeffrey L. Smith